RESEARCH

OCTOBER 2010

MELBOURNE CBD

Office Market Overview

Knight Frank

HIGHLIGHTS

- The Melbourne CBD market remained very resilient over the past six months, adding 74,453 m² of new supply, whilst absorbing 68,996 m² in the last half.
- Potential backfill space has emerged as a determinant to timing of further vacancy rate falls. Major tenants either relocating to Docklands or consolidating operations will vacate 104,000 m² of office space to July 2012.
- Net face rental growth and a marginal reduction in incentives led to average net effective rents rising to $355/m² as at October 2010. Effective rents are expected to experience strong growth from 2012, once the backfill space has been absorbed and incentives pull back further.
- With the major listed players now largely re-capitalised, there is evidence of select A-REIT's with strong balance sheets attempting to join the super funds, off-shore investors and privates as participants in a new round of acquisition activity.

MELBOURNE CBD OVERVIEW

Table 1
Melbourne CBD Commercial Market Indicators October 2010

Market	Total Stock (m²) ^	Vacancy Rate (%) ^	Annual Net Absorption (m²) ^	Annual Net Additions (m²) ^	Average Prime Net Effective rent ($/m²)	Incentives (%)	Average Prime Core Market Yields (%)
Prime	2,402,535	5.6	135,817	170,364	355	16 - 20	6.85 - 7.50
Secondary	1,658,845	7.8	-44,973	-2,426	245	18 - 22	8.00 - 9.25
Total	**4,061,380**	**6.5**	**90,844**	**167,938**			

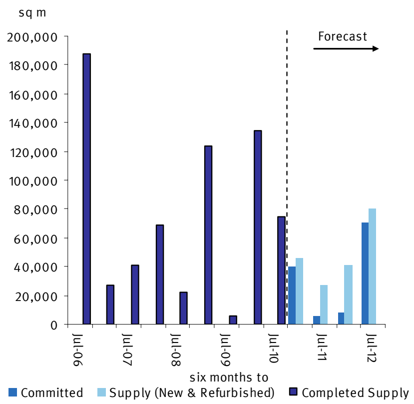
Source: Knight Frank/PCA ^ as at July 2010

SUPPLY & DEVELOPMENT ACTIVITY

The Melbourne CBD office market welcomed an additional 74,453 m² of new space in the six months to July 2010. This completion marks the end of the current major supply cycle and the beginning of a period relatively devoid of any significant new supply. This situation is almost entirely attributed to the global recession as lenders restricted the flow of debt and altered risk profiles and feasibilities.

Highlighting looming supply inadequacies, the quantum of new space that was added over the past half is expected to exceed the total annual new additions for the coming 12 month period of 72,800 m². Of that space almost 70% is already committed. PBL, Telstra and BP have all committed to 39,800 m² of space at 717 Bourke Street in the Docklands precinct. Holding Redlich's pre commitment to 555 Bourke Street will see almost fifty percent of the 15,000 m² Julliard Group's extension of the St James building occupied. Australia Post's former home at 321 Exhibition Street will come back online next year following a refurbishment that will deliver 31,000 m² of space back to the market. Origin Energy has reportedly agreed to occupy 23,953 m² of this building from August 2011.

Figure 1
Melbourne CBD Supply Scenario
New & Refurbished office space

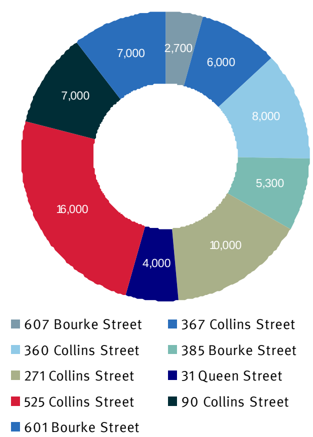


Source: PCA / Knight Frank Research

Backfill Space

It is anticipated that as much as 104,000 m² of office space within the CBD will become vacant backfill by July 2012. With little new supply that's uncommitted, backfill space has emerged as a potential drag on falling vacancies. As major tenants move to accommodation in Docklands or centralise their operations, space will become available within a number of CBD office towers. Telstra's consolidation will reportedly see as much as 28,000 m² left vacant, while other tenants including Optus, Origin Energy and ME Bank will also relocate during 2011. The composition of space left vacant is predominantly made up of A grade. As tenants seek to move from secondary to prime accommodation, demand for this space will remain strong. Meeting tenant requirements for large contiguous space may pose the greatest issue.

Figure 2
Melbourne CBD Backfill profile
2011 Calendar year



Source: Knight Frank Research

MAJOR OFFICE SUPPLY

1. 800 Collins Street - 28,650 sq m
Lend Lease - Q1 2010 (Complete)

2. 400 Docklands Drive - 14,000 sq m
MAB - Q4 2009 (Complete)

3. 717 Bourke Street - 39,800 sq m
Metier III - Q3 2010

4. 735 Collins Street - 38,000 sq m
Kuok / Walker - Q4 2012

5. 357 Collins Street - 22,000 sq m
Australand - Q4 2011

6. 555 Bourke Street - 15,000 sq m
Julliard

7. 745 Collins Street - 30,000 sq m
Kuok / Walker - Q4 2012

8. The Goods Shed - 11,000 sq m
Kuok / Walker

9. Bourke Junction, North Tower - 62,000 sq m
ISPT/Cbus Property

10. 990 Latrobe Street - 13,500 sq m
Digital Harbour

11. 171 Collins Street - 27,700 sq m
Charter Hall/CBus

12. 567 Collins Street - 52,000 sq m
APN / Leighton Properties

13. 399 Bourke Street - 63,000 sq m
Brookfield Multiplex

14. 385 Bourke Street - 27,000 sq m
Colonial First State

15. 275 Lonsdale Street - 22,000 sq m
Colonial First State

16. 300 Lonsdale Street - 22,000 sq m
GPT Group

17. 644 Collins Street - 45,000 sq m
Mirvac

18. 160 Collins Street - 15,000 sqm
APN

19. 395 Docklands Drive - 22,000 sq m
MAB

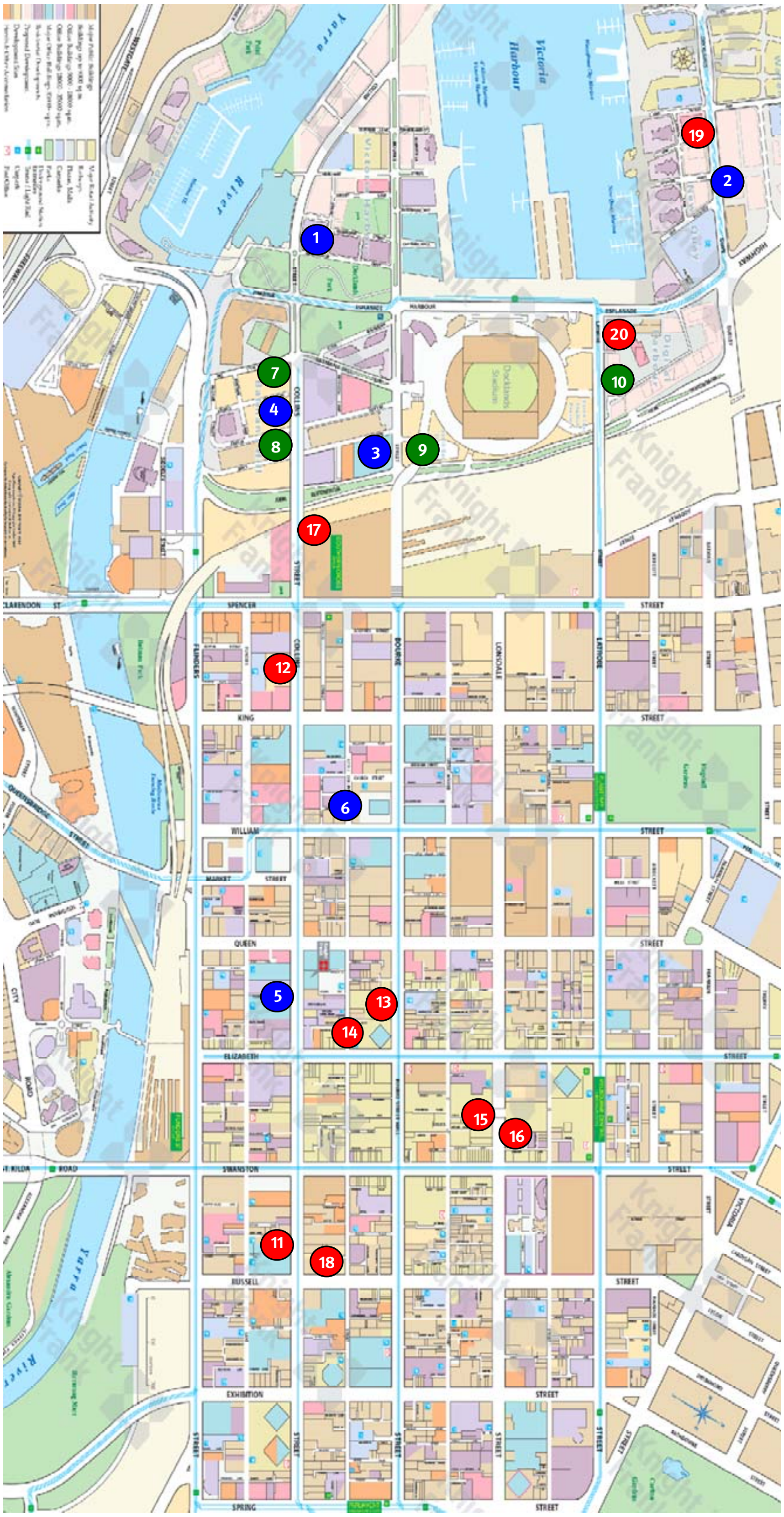
20. 1000 Latrobe Street - 32,500 sq m
Digital Harbour

Completed/Under Construction

DA Approved/Stage2

Mooted

Office NLA quoted



TENANT DEMAND & RENTS

The amount of vacant office space in the Melbourne CBD dipped marginally during the six months to July 2010 to 263,288 m² bringing total vacancy to 6.5%. At the breakdown, direct vacancy increased slightly to 5.5% whilst sub lease space tightened to 1.0%. With business confidence rebounding, the demand for stock at the top end of the market is on the rise. Premium grade vacancy plummeted from 10.6% to 5.9%, representing a flight to quality by tenants with renewed confidence and are eager to secure accommodation prior to expected rental growth occurring. Contributing to the fall in vacancy of premium grade stock, Ebsworth HWL and Nexia have leased previously vacant space at 530 Collins Street, whilst Thomas Playford have committed to the Rialto. Conversely, additional supply forced an increase in vacancy for A-grade stock. Over half of all new supply added to the CBD market within the 12 month period to July 2010, was A-grade. Secondary office vacancy rose; with B and C-grade stock being given up for better quality space.

At a precinct level, the Western core which accounts for the majority of office space in the CBD market, firmed from 8.3% to 7.7%.

Table 2
Melbourne CBD Vacancy Rates
January 2010 – July 2010

Grade	Jan-10 %	Jul-10 %
Premium	10.6	5.9
A Grade	4.5	5.5
B Grade	8.0	8.4
C & D Grade	6.9	7.0
Total	6.6	6.5

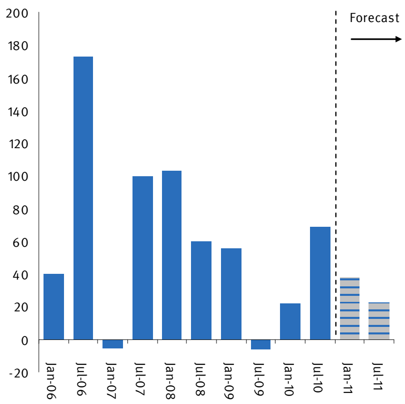
Source: PCA /Knight Frank

Despite over 42,000 m² of new space added in Docklands this half, the vacancy only increased marginally to 2.6%. With just 12,000 m² of office remaining, Docklands is expected to have near zero vacancy within the coming six months. Of the remaining five precincts, all but Spencer experienced a drop in vacancies.

Net Absorption

Following several periods of net absorption falling short of the long term average, it appears increasing demand is now being expressed with net absorption reaching 68,996 m² for the last half – the highest six monthly net absorption result since the start of 2008.

Figure 3
Melbourne CBD Net Absorption
(sq m) 2006-2011



Source: PCA / Knight Frank Research

BY MID 2012, MELBOURNE CBD OFFICE VACANCY SHOULD FALL TO 5.4%.

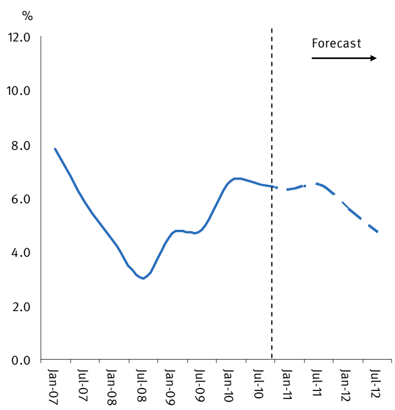
Importantly to note, hidden within the total CBD net absorption figure is an emerging trend of dwindling premium grade supply that will have a notable impact on the office market over the coming twelve months. Premium grade stock, despite being a small proportion of overall stock, experienced one of the highest net absorption results on record, with 70,463 m² of stock absorbed over the year to July 2010. With demand for space at this grade set to intensify, tenants will have limited opportunity to find suitable space. The likely result is rents for Premium assets skewing prime rent growth higher.

Anticipated Vacancy Levels

The vacancy rate in the Melbourne CBD dropped to 6.5% as absorption countered the significant amount of space added to the market in the past twelve months. Enquiry levels have been choppy with interest cooling pre-election as the corporate world adopted a wait and see mindset.

As previously mentioned the determining factor in forecasting vacancy levels over the coming twelve months is how well the backfill stock is absorbed by the market. Knight Frank anticipates that much of this will wash through by the end of 2011, stalling further decreases in the near term, whilst creating a situation post 2011 whereby limited supply will see vacancy across the total CBD office market trending downwards. By mid 2012 the Melbourne CBD office vacancy is forecast to fall to 5.4%.

Figure 4
Melbourne CBD Vacancy Rates
2007-2012



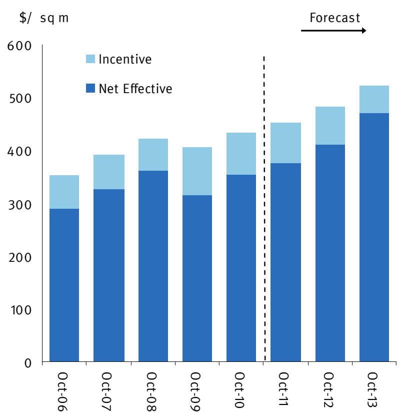
Source: PCA / Knight Frank Research

Demand & Rental Levels

Following a period of dampened demand, the Melbourne office market is expected to shift up a gear over the coming year. Financial and business services are becoming more active as the states positive economic outlook spurs renewed interest in expansionary measures. Going forward tenant relocations are expected to be affected by the availability of contiguous office space, particularly A-grade stock greater than 1,000 m². Major tenants will have limited options which should see a competitive leasing environment. Several large pre-commitments have been concluded in the past six months, including Pearson, Marsh Mercer, ATO, NAB and Melbourne Water in the Docklands and Origin Energy at 321 Exhibition Street. Anecdotal evidence suggests there may be several more pre-commitments on the way. In a sign the worst is largely behind us, prime rents experienced modest growth in the last half, making inroads into reversing declines experienced during the GFC. Average prime (premium and A-grade) net effective rents to October 2010 were $355/m²; while secondary effective rents averaged $245/m². Incentive levels tightened slightly, with prime incentives between 16-20% and secondary higher at 18-22% of the net value of the lease. There were some exceptions however, with anecdotal evidence suggesting some deals in the Docklands precinct attracted single figure incentives.

Looking ahead moderate growth is expected in the short term as backfill stock is absorbed by the market. In the absence of suitable new space, a pick up in white collar employment growth and positive net absorption, average net effective rents could breach the $400/m² mark as soon as mid 2012. With a clear flight to quality scenario present, secondary space is expected to take longer to bounce back. With vacancy rates heading north across both B and C grade stock, rents are expected to remain relatively flat in the near term. Tight vacancies and comparable rents in the greater metropolitan market may generate demand for well priced secondary CBD stock.

Figure 5
Melbourne CBD Rents & Incentives
Net Rentals - October 2010



Source: Knight Frank Research

Table 3
Recent Leasing Activity (New Leases & Significant Renewals over 2,000m²) Melbourne CBD

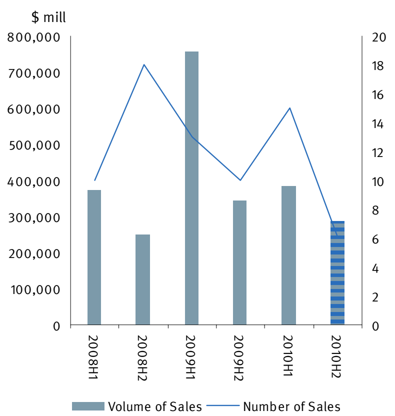
Address	Region	Estimated Rental ($/sq m)	Area (sq m)	Term (yrs)	Tenant	Start Date
800 Bourke Street*	Docklands	380	62,000	15	NAB	Q4 – 13
735 Collins Street *	Docklands	420	35,000	10	ATO	Q2 – 12
321 Exhibition Street	North East	390	25,000	10	Origin Energy	Q2 – 12
300 Latrobe Street	Flagstaff	Undisclosed	23,400	12	Telstra ^	Q1 – 13
990 Latrobe Street*	Docklands	385	12,375	15	Melbourne Water	Q2 – 12
717 Bourke Street	Docklands	350	10,144	10	BP	Q4 – 10
360 Elizabeth Street	Civic	420	9,174	12	ME Bank	Q2 – 11
717 Bourke Street	Docklands	Undisclosed	9,000	10	Telstra	Q4 – 10
717 Bourke Street	Docklands	Undisclosed	8,078	10	PBL Media	Q4 – 10
735 Bourke Street *	Docklands	Undisclosed	8,000	10	Pearson	Q2 – 12
360 Elizabeth Street	Civic	Undisclosed	7,265	10	Allianz	Q2 – 11
1010 Latrobe Street	Docklands	330	4,500	10	NBN	Q2 – 10
161 Collins Street	Civic	365	4,180	10	IOOF	Q1 – 11
525 Collins Street	Western	400	3,120	10	Thompson Playford	Q2 – 10
150 Lonsdale Street	Civic	305	1,100	5	Program Group	Q2 – 10
31 Queen Street	Western	365	964	7	HayesKnight	Q4 – 10
31 Queen Street	Western	365	960	10	People Bank	Q4 – 10
461 Bourke Street	Western	245	843	5	Retail Directions	Q3 – 10
303 Collins Street	Western	285	759	5	Shine Technologies	Q2 – 10
60 Collins Street	Eastern	350	750	7	Indec	Q2 – 10
45 William Street	Western	290	440	5	Audrey Page	Q4 – 10

Source: Knight Frank * Pre-Lease deal ^ Lease Renewal

INVESTMENT ACTIVITY & YIELDS

After a relatively slow H2 2009, it appears investment activity is once again gaining some momentum. There has been a noticeable spike in interest over the past six months with several major sales in the Melbourne CBD signalling a return of confidence that escaped investors through recent turbulent times. While there was increased sales activity, the volume of sales was only marginally higher than H2 2009; re-affirming the strength of the private investor market and their ability to fund assets, in particular secondary, throughout the cycle regardless of limited access to debt facilities.

Figure 6
Melbourne CBD Major Sales
Sales Volume › $5mil ($) & number



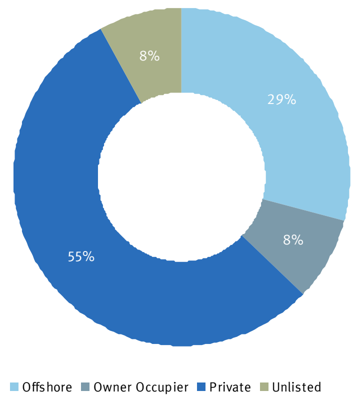
Source: Knight Frank Research
Note: H2 2010 is YTD only

As highlighted in figure 6, H1 2010 saw a modest increase in the number of completed office transactions, predominantly at the lower end of the market. Two months into the second half of 2010 and sales/volumes are tracking relatively strongly with sales of $361 million already accounted for and several others in due diligence.

Melbourne CBD has traditionally been a stronghold for private investors seeking steady returns in the commercial markets. With boxes still being ticked on underlying fundamentals and the GFC now visibly in the rear vision, the states appeal is extending to a wider audience with offshore investors, AREIT's and unlisted funds now investigating opportunities to capitalise on one of the nations better performing CBD office markets. The purchaser profile is evolving as institutional and offshore investors take a greater slice of the market.

In the largest transaction over the past twelve months, Hong Kong based CLSA purchased 485 La Trobe Street for $140.1 million on a core market yield of 8.14%. In a further vote of confidence for the Melbourne CBD office market, developer Australand paid $45.0 million for the former stock exchange building at 357 Collins Street and intends to refurbish the building on a speculative basis to capture the strengthening demand environment. Most recently, Charter Hall has secured the remaining half share in 570 Bourke Street for $77.0 million from former joint owner Perron Group. In addition to this, prime office towers at 737 Bourke Street, 717 Bourke Street and the South Wharf complex comprise over $400 million worth of assets currently under due diligence, reportedly to two foreign buyers and one local institution. This underscores the relative investment demand for prime assets and the increased liquidity in the market compared to the bottom of the market in 2008/09.

Figure 7
Melbourne CBD Purchaser Profile
Office Sales › $5mil - Year to July 2010



Source: Knight Frank Research

The market is providing solid opportunities for investors to capitalise on what arguably presents as the trough in the cycle. Dockland assets with high WALE's will continue to attract interest from offshore institutions.

Table 4
Major Sales Transactions – Melbourne CBD

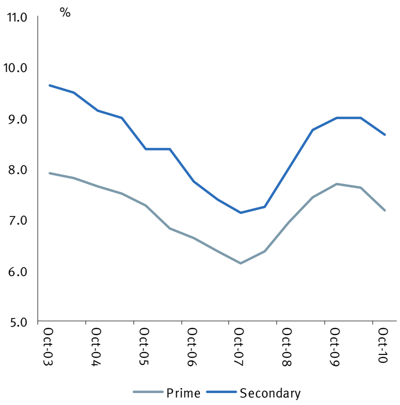
Address	Price ($ mil)	Core Market Yield (%)	NLA (m²)	$/m² NLA	WALE (Years)	Purchaser	Sale Date
485 La Trobe Street	140.1	8.14	33,814	4,143	6.2	CLSA (offshore)	Aug-2010
570 Bourke Street (50% share)	77.0	8.86 ^	35,089	4,624	4.1	Charter Hall	Sep-2010
160 Harbour Esplanade	54.2	6.95	7,980	6,792	14.8	Private Investor	Jul-2010
35 Spring Street #	45.5	9.01 ^	12,984	3,506	5.0	Cbus	Aug-2010
1 Spring Street (50% share)	67.0	7.50	31,776	4,218	9.1	Private Investor	Mar-2010
357 Collins Street **	45.0	VP	22,000	2,045	VP	Australand	Mar-2010
383 King street	34.0	9.13	12,975	2,620	3.3	Henkell Brothers	Feb-2010
356 Collins Street	28.0	7.72	7,211	3,890	4.5	Private Investor	Apr-2010

Source: Knight Frank ^ Passing yield ** Building to be fully refurbished VP Vacant Possession # Potential development site

Figure 8

Melbourne CBD Average Yields

Prime & Secondary core market yields



Source: Knight Frank Research

There is market consensus that a tightening of yields of up to 50 basis points has occurred since early this year relative to some book values which may have extended too far on the downside and were based only upon "notional" yields due to the absence of sales at the time. We expect that yields will remain relatively stable over the next year, with a firming bias for well leased, quality grade assets. Current prime yields range between 6.85% – 7.50%, while secondary assets trade in an average range of 8.00% – 9.25%. The divergence between prime and secondary yields seems unlikely to diminish in the short term as relocations from B and C-grade stock into prime space creates a vacuum on the secondary market impacting passing incomes and vacancy levels.

485 Latrobe St, Melbourne.
Purchased by CLSA for $140.1 million

OUTLOOK

The Australian economy continues to make headway towards an advanced recovery despite lingering fears over the fragility of the global economy. Concerns over European sovereign debt and a stalling US economy haven't yet materialised as significant obstacles to local growth. More recently the largest issue has been the control of simmering inflation levels and market jitters generated through ambiguity on the incumbent government's forward policy. At a state level, economists have suggested Victoria faces the threat of being a victim of a two speed economy. However, this would appear unlikely in the short to medium term given that the solid fundamentals that drove the states prosperity prior to the GFC continue to prevail. Underpinning the states success, Victoria has outpaced most of the nation on final demand, jobs creation and continues to be supported strongly by both public and private investment. From the investor standpoint, the Melbourne CBD office market currently provides, and will continue to in the short term, a compelling case as arguably the nation's strongest commercial investment market.

Underlying demand for CBD office space is set to expand over the coming year as business confidence builds on the back of a generally positive reporting season. Though falling short of the long term annual average; net absorption is expected to outstrip new supply additions over the coming six months. A gradual increase in white collar employees will support pre-lease activity and generally solid take up of space.

Emerging as the key determinant to near term decline in the vacancy rate and subsequent rental growth is the influx of backfill space due to come to market between now and the end of 2011. Major tenants have taken advantage of large floor plates, custom builds and relatively low rents in the Docklands precinct and will vacate CBD locations over the next two years. With strong forecast net absorption, vacancy rates should decline towards 5%. There is 72,800 m² of new supply expected to come on line to July 2011, of which 33,000m² is refurbishment space. While 717 Bourke Street will deliver 39,800 m² of new space in H2 2010, it is almost entirely pre-committed. Building extensions and refurbishments at 321 Exhibition, 555 Bourke, 360 Elizabeth and 222 Exhibition Street's will provide the only additional new space that hasn't been fully pre-leased.

The expected benign supply pipeline could see a renewed push on efforts to commence development or progress projects that had been shelved over the past two years. A number of office developments have reportedly garnered interest from prospective tenants with net face rents of $550 - $600/m² needed for construction in the "traditional" CBD to proceed. If economic rents can be attained it would still mean any significant completion is approximately 2-3 years away.

THE MELBOURNE CBD IS ARGUABLY THE NATIONS STRONGEST COMMERCIAL INVESTMENT MARKET

On many levels, indications are for a favourable scenario for owners of prime space. The impending supply shortage is bound to see vacancy rates firm which in turn will kick start solid rental growth through to 2013. As a result, yields should trend downwards, boosting capital values.

Recent sales and enquiry supports the notion that REIT's and Super Fund's are positioning themselves for further acquisition activity. This will provide strong competition to the offshore groups, which in recent times have extended their exposure in Australia as uncertainty in European and US markets persist.

RESEARCH

Americas
USA
Bermuda
Brazil
Caribbean
Chile

Australasia
Australia
New Zealand

Europe
UK
Belgium
Czech Republic
France
Germany
Hungary
Ireland
Italy
Monaco
Poland
Portugal
Russia
Spain
The Netherlands
Ukraine

Africa
Botswana
Kenya
Malawi
Nigeria
South Africa
Tanzania
Uganda
Zambia
Zimbabwe

Asia
Cambodia
China
Hong Kong
India
Indonesia
Macau
Malaysia
Singapore
Thailand
Vietnam

The Gulf
Bahrain

Knight Frank Newmark Global

Knight Frank Research

Justin Mahnig
Research Manager – Research VIC
+61 3 9604 4713
Justin.mahnig@au.knightfrank.com

Matt Whitby
National Director – Research
+61 2 9036 6616
Matt.whitby@au.knightfrank.com

Jennelle Wilson
Associate Director – Research QLD
+61 7 3246 8830
Jennelle.wilson@au.knightfrank.com

Valuation Contacts

Joe Perillo
Joint Managing Director - Victorian Valuations
+61 3 9604 4617
jperillo@vic.knightfrankval.com.au

Michael Schuh
Director – Victorian Valuations
+61 3 9604 4726
mschuh@vic.knightfrankval.com.au

Commercial Agency Contacts

Michael Nunan
State Director - Leasing
+61 3 9604 4681
Michael.nunan@au.knightfrank.com

Mark Rasmussen
Director – CBD Leasing
+61 3 9604 4702
Mark.rasmussen@au.knightfrank.com

Ben Ward
Director – CBD Leasing
+61 3 9604 4677
Ben.Ward@au.knightfrank.com

Paul Henley
National Director
+61 3 9604 4760
Paul.henley@au.knightfrank.com

Langton McHarg
Director – CBD Sales
+61 3 9604 4619
Langton.Mcharg@au.knightfrank.com

Paul Burns
Managing Director - VIC
+61 3 9604 4610
Paul.burns@au.knightfrank.com

Knight Frank Research provides strategic advice, consultancy services and forecasting to a wide range of clients worldwide including developers, investors, financial and corporate institutions. All recognise the need for the provision of expert independent advice customised to their specific needs.

Knight Frank Research reports are also available at www.knightfrank.com.